

State Water Resources Control Board

TO: Kailyn Ellison
Attorney
Office of Enforcement

FROM: Gerald Horner
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DATE: May 23, 2016

SUBJECT: KEVIN HINMAN'S ABILITY TO PAY A PROPOSED \$100,000 ADMINISTRATIVE CIVIL LIABILITY (ACL)

This is in response to your request to reevaluate an earlier determination of Kevin Hinman's (Hinman) ability to pay a proposed ACL in the amount of \$100,000 by considering additional documentation submitted by Hinman. The original determination was that Hinman was able to pay the proposed \$100,000 ACL.

Documents submitted for consideration on May 16, 2016 were: 1) a statement from Seong Chan, accountant, representing Hinman; and 2) the original Financial Data Request Form (FDRF) with additional data for the year 2015.

I have reviewed the submitted documents and I have concluded that Hinman still possess the financial resources to pay the proposed ACL.

RESULTS

Ability to pay is determined by the person or business's cash flow and net worth. The Discharger can afford the proposed ACL based on projected annual cash flow of \$48,969 and current net worth of \$2,482,540.

Cash flow

Cash flow is determined by average annual income minus annual living expenses. Average annual income, in this case, is \$83,480, and annual living expenses is assumed to be \$34,511 resulting in an available cash flow of \$48,969.

An annual cash flow of \$48,969 is adequate to make payments on a five-year loan of \$100,000 to pay the ACL without undue hardship to him or his business.

Net Worth

Securing a loan to pay the ACL would require adequate collateral. Hinman's total assets amount to \$4,768,642, liabilities amount to \$2,286,102 resulting in a net worth, or equity, of \$2,482,540. The principal asset reported by Hinman is the facilities of Delta Waterways LLC valued at \$4,139,686. The property has a mortgage with a loan balance of \$2,220,146.

A net worth of \$2,482,540 is adequate collateral to secure a \$100,000 loan to satisfy the ACL.

SUGGESTED CHANGES AND ANALYSIS

Chan requested that a number of addition financial changes be considered for the ability to pay analysis. These changes and my responses are as follows.

Reduction in Mortgage Principal

The previous version of the Request Form was done before the final adjustments were made to the accounts. This updated version reflects the most current classification of accounts.

As you can see from the attached updated version, there are cash outflow items need to be consider to determine the ability to pay by Holland Riverside Marina. These cash outflow items are as follows:

Principal loan amount reduced by \$314,321 at end of 2015 (\$2,534,467 minus \$2,220,146).

The change in the principal loan amount is not a cash flow item. It is an entry in the Liabilities section of the Net Worth statement (Table 1), therefore, the estimated cash flow is not effected.

Table 1. Revised Liabilities.

Source: Page 7, Revised FDRF. Submitted by Kevin Hinman on 5/12/2016.

B. Liabilities and Stockholder's Equity

		2014	2013	2012	2011	2010	2015
Loans Principle	\$						
Monthly Payment	\$						
Mortgages Principle	\$	2,534,467	2,838,936	2,575,354	2,617,537	2,559,815	2,220,146
Monthly Payment	\$						
Accounts Payable	\$		681	44,676		8,043	
Deferred Taxes	\$	65,956					65,956
Insurance Premiums	\$						
Other	\$						

The source of the capital to reduce the loan was from friends and therefore assumed to be outside of the business. Since there is no offsetting liability (Table 1), the reduction of the loan principal by \$314,321 increases net worth by this amount.

Capital Expenditures for Facility Improvements

Capital Expenditure (Improvements) in 2015 of \$58,368 (\$4,139,686 minus \$4,081,318).

The revised FDRF indicates that the value of business facilities increased from \$4,081,318 in 2014 to \$4,139,686 in 2015 due to improvements costing \$58,368 (Table 2). Again the source of capital funds is from friends and it was not claimed as a deductible expense. Therefore, cash flow has not changed. If this was a deductible expense, an amended IRS Income tax return should have been filed with the IRS and a copy of that amended tax return made available for this analysis. Net worth however, increases by the amount of the capital improvement of \$58,368.

Table 2. Revised Assets.

<u>A. Assets</u>		2014	2013	2012	2011	2010	2015
<u>Cash</u>	\$	1,353	33,754	93,124	53,264	190,784	1,952
<u>Securities</u>	\$						
<u>Facilities</u>	\$	4,081,318	4,081,318	3,583,499	3,511,234	3,232,717	4,139,686
<u>Depreciation</u>	\$	(1,178,709)	(911,619)	(642,506)	(375,259)	(109,411)	(1,421,872)
<u>Equipment</u>	\$						
<u>Depreciation</u>	\$						
<u>Inventory</u>	\$	0	0	0	0	0	
<u>Accounts Receivable</u>	\$	51,171	54,204	45,342	30,312	21,623	55,458
<u>Other</u>	\$	43,376	45,538	47,701	49,864	52,434	41,212
<u>TOTAL ASSETS</u>	\$	2,998,509	3,303,195	3,127,160	3,269,415	3,388,147	2,816,436

Source: Page 7, Revised FDRF. Submitted by Kevin Hinman on 5/16/2016.

Living Expenses

Kevin Hinman's personal living expenses.

Hinman's actual living expenses were not used in the analysis. Hinman's detailed living expenses were not included on the FDRF because that FDRF is specifically designed for a business organization. In lieu of the missing information, the national median living expenses for a household of one of \$32,868 was used in the analysis.¹

Net Income

As we both agreed that the net income for 2015 is approx. \$82,156 which is calculated by adding the depreciation charges of \$ 243,163 (\$1,421,872 minus \$1,178,709) to the net loss of \$161,007.

This is true, but in preparing this response I discovered that I had not included the amortization of mortgage costs entered on line 19 of Schedule E, IRS Form 1040 (Table 3). This amount should have been added to the depreciation entered on line 18. Adding the amortization amount of \$2,163 to depreciation of \$240,244 and subtracting the net loss of \$158,088 results in a net income of \$84,319.²

¹ Bureau of Labor Statistics, U.S. Dept. of Commerce.

² It is noted that the numerical values cited by Chan are different than the those reported in the Form 1040 originally submitted (Table 3). A revised IRS Form 1040 for 2015 was not submitted.

Table 3. Amortization of Mortgage Costs.

Expenses:					
5	Advertising	5	626		
6	Auto and travel (see instructions)	6	8,258		
7	Cleaning and maintenance	7	1,820		
8	Commissions.	8			
9	Insurance	9	1,832		
10	Legal and other professional fees	10	4,817		
11	Management fees	11			
12	Mortgage interest paid to banks, etc. (see instructions)	12	100,559		
13	Other interest.	13			
14	Repairs.	14	10,725		
15	Supplies	15	5,535		
16	Taxes	16			
17	Utilities.	17	40,892		
18	Depreciation expense or depletion	18	240,244		
19	Other (list) ► AMORTIZATION OF MORTGAGE COSTS	19	2,163		
20	Total expenses. Add lines 5 through 19	20	417,471		
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21	(158,088)		
22	Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	(158,088)	() (
23a	Total of all amounts reported on line 3 for all rental properties	23a	259,383		
b	Total of all amounts reported on line 4 for all royalty properties	23b			
c	Total of all amounts reported on line 12 for all properties	23c	100,559		
d	Total of all amounts reported on line 18 for all properties	23d	240,244		
e	Total of all amounts reported on line 20 for all properties	23e	417,471		
24	Income. Add positive amounts shown on line 21. Do not include any losses	24			
25	Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	(158,088)		
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26	(158,088)		

Source: Kevin Hinman, Schedule E (Form 1040) 2015, page 1.

Subsequent changes were made to income estimates for 2011 through 2014 (Table 4).

Table 4. Revised INDIPAY Tax Return Data Inputs

	Applicant				
	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>
Wage income					
Taxable interest income					
Tax-exempt interest income					
Dividend income					
Alimony received					
Business income or loss		-67,639	-128	-69	243
Capital gain or loss					
Other gains or loss					
Total IRA distributions					
Total pensions or annuities					
Farm income or loss					
Total social security					
Other income					
Real estate taxes deduction					
Depletion					
Depreciation/amortization on business accounts (Sch E, line 19)	2,163	2,163	5,442	5,442	5,442
Taxes paid on rental properties			3,622	58,882	57,679
Depreciation or depletion on rental properties	240,244	322,532	533,446	541,481	561,001
Total income/loss from rental properties/royalties	-158,088	-174,449	-163,494	-217,408	-266,429
Partnership/S corporation income			714	659	111

Source: Hinman revised INDIPAY results. U.S. E.P.A. INDIPAY Model Version 3.5.0, July 2015, www.epa.gov/enforcement/econmodels.html

The revised weighted average income for 2014 and 2015 is \$83,480 (Table 5). Incomes for 2011 through 2013 were not considered relevant for this analysis since major restructuring of the business was made prior to 2014.

Table 5 Revised Summary of Applicant's Income Sources (as reported on tax returns).

	2015		2014		2013		2012		2011		Average
Wages and salaries	0%		0%		0%		0%		0%		0
Interest and dividends	0%		0%		0%		0%		0%		0
Capital gains/losses	0%		0%		0%		0%		0%		0
Retirement-related	0%		0%		0%		0%		0%		0
Business	84,319	100%	82,607	100%	375,980	100%	330,105	100%	300,368	100%	234,676
Farm	0%		0%		0%		0%		0%		0
Other	0%		0%		0%		0%		0%		0
Total	84,319		82,607		375,980		330,105		300,368		234,676
Weight	51%		49%		0%		0%		0%		
Weighted Income	43,003		40,477								83,480

Source: Revised INDIPAY results. U.S. E.P.A. Model Version 3.5.0, July 2015.

Accounting for Principal Loan Payments, Mortgage Loan Balance and Asset Value

In order to ascertain the ability to pay the fine, we need to present the true cash flow instead of the net income/loss because the net income/loss does not reflect the principal loan payments which are required by the lenders and necessary capital improvements for the tenants and authorities. I agree with you that in some cases that the principal payments may help to reduce the loan amount and thus increase the equity value of the property, especially when the property can be sold easily.

However, for this case here, Kevin can't sell the marina because the overall loan amount on the marina is greater than the market value of the marina; therefore the principal loan payment amount does not help to increase the equity value. As Kevin stated in the meeting, he has the passion to continue to operate the marina knowing that his sweat money goes to paying a loan that is secured by the marina which has a market value lower than the total loan amount.

First, payments to principal immediately and directly increases net worth. This is a generally accepted accounting principle.

Second, the unpaid balance of a mortgage is the responsibility of the borrower regardless of the current asset value of the property used as collateral.³ Asset value can be influenced by a number of parameters such as current market conditions and the physical condition of the facility. However, if the borrower defaults on the mortgage, the holder takes title to the property. If the subsequent sale of the property does not satisfy the loan balance mortgage, the lender may obtain a judgment to pursue the borrower's assets, such as bank accounts, cars and investments. Therefore, payments made to reduce the loan principal amount represents an increase in net worth regardless of the value of the collateral. Since it is considered an increase in net worth, it cannot also be charged as an operational expense.

Third, the marina can be sold even if the property value is less than the loan balance.⁴ The lender has every incentive to negotiate a settlement that would allow the transfer of ownership. This is routine practice in the sale of underwater properties.

Fourth, Chan states above that the 2015 value of the property was \$4,139,686 (Table 2). This represents an increase of \$58,368 from 2014. If the asset value had declined, it should be reflected in the FDRF asset value table. It was not. In addition, no documentation was submitted on the FDRF, or independently of a decline in property value. The asset table in the FDRF shows a 2010 property value of \$3,232,717 increasing annually to \$4,139,686 in 2015 (Table 2). It should also be noted that the depreciation shown on Table 2 does not reflect the true change in asset value. Depreciation is used to expense the purchase of a capital asset for income tax purposes only. It is calculated using an IRS depreciation schedule appropriate for the type of property and it is not based on actual market value or physical conditions.

Personal Loans

The net income of approx. \$82,000 did not include the loan principal payment, capital expenditure and personal living expenses. After adding back the cash outflow of loan principal payments, capital expenditure and personal living expenses, there is no cash left but more debt. Kevin is very blessed to have good friends lending him personal loans to pay for all the cash outflows last year.

The principal payments, capital expenditures and living expenses were addressed above. The personal loans need to be entered in Section B of the FDRF (page 7) and in Item 17 of the FDRF, "Loans Payable" (page 8) in order to be included as liabilities in the net worth statement. They were not. It is also noted that at the top of page 7 of the FDRF, the applicant is requested to submit audited documents if available. This has not been followed in submitting the revised FDRF or, for that matter, in submitting the original FDRF.

³ Collateral is the asset that secures the mortgage loan.

⁴ Referred to as an underwater property.

Summary Statement

Kevin is struggling to keep the marina out of foreclosure. He is behind the mortgage payments and taxes. He has tried his very best to keep the marina running with all the debts. Please help him to present the true cash flow situation to the Board.

It is noted that deferred taxes owed of \$65,965 for the years 2014 and 2015 appears in the liabilities section (Table 1). However, the remainder of the assertions made in this summary statement is contrary to the information submitted on Table 1. Loans principal and monthly payment liabilities are zero. Mortgage monthly payment, accounts payable, insurance premiums and "other liabilities" are zero. This is a direct contradiction of the summary statement. Table 1 indicates a financially healthy business.

Revised Ability to Pay Results

The revised ability to pay analysis concludes that Hinman has the ability to pay the \$100,000 ACL (Table 6).

Table 6. Hinman's Revised Ability to Pay a \$100,000 Administrative Civil Liability.

Table C: Applicant's Revised Ability to Pay a \$100,000 Administrative Civil Liability:		Sought Amount: \$100,000	
Ability-to-Pay Test A - Cash Flow			
Present value (5 years @ 2.2% inflation & 9.9% discounting)	▼		\$197,942
Affordable penalty/contribution (reduced for 5% contingency)	▼		\$100,000
Under Test A, the entire sought amount is affordable.			
Ability-to-Pay Test B - Debt Capacity			
Maximum affordable annual debt payments (at 36% limit)	▼		\$30,053
Maximum affordable additional debt payments (at 9.9% interest rate)			\$30,053
Affordable penalty/contribution (based on 5-yr debt repay and 5% contingency)			\$100,000
Under Test B, the entire sought amount is affordable.			
Impact on Applicant's Financial Status	Before Payment	After Payment, Using:	
<i>[scroll to page bottom for income breakdown]</i>		Test A	Test B
Income (using 0.3 smoothing constant)	\$83,480	\$83,480	\$83,480
90% of \$92,900 median family income in Contra Costa County			
Living expenses (w/ 5% contingency)	\$34,511	\$60,487	\$60,487
105% of \$32,868 nat'l median for household of 1	▼		
Available cash flow	\$48,969	\$22,993	\$22,993
Assets	\$4,768,642	\$4,768,642	\$4,768,642
Liabilities	<u>\$2,286,102</u>	<u>\$2,386,102</u>	<u>\$2,386,102</u>
Net worth	\$2,482,540	\$2,382,540	\$2,382,540
Annual debt payments (w/ 5% contingency)	\$0	\$25,976	\$25,976
Debt payments as percent of income	0.0%	31.1%	31.1%

Source: Hinman revised INDIPAY results. U.S. E.P.A. Model Version 3.5.0, July 2015.

Two tests are applied in the ability-to-pay analysis: Test A "Cash Flow" and Test B "Debt Capacity".

Test A, "Cash Flow," first determines the present value of the applicant's future cash flow. Cash flow is calculated as the applicant's average income (with weights of 51% for 2015 and 49% for 2014), minus living expenses that is increased by a five percent contingency allowance. INDIPAY projects this cash flow out for five years by adjusting for inflation and then discounting it back to a present value using a 9.9% discount rate. The sum of this cash flow, reduced by a five percent contingency allowance, is the affordable penalty or contribution under Test A.

Test B, "Debt Capacity," first determines the maximum affordable annual debt payments, calculated as the applicant's average income multiplied by the maximum debt payments as a percent of income. The default value is 36 percent⁵. The maximum affordable additional debt payments are then equal to the above figure minus current debt payments which are zero. This annual payment amount, aggregated over the five-year repayment period, is the affordable penalty or contribution under Test B.

The impact of paying the ACL upon the applicant's financial status is also provided in Table 6. The first column of figures for each row displays the applicant's current status before payment of the penalty or contribution, and the next two columns display the status after payment under Tests A and B. Income is identical across all three columns, and INDIPAY also shows how the applicant's income compares to the county- and household-size-specific median. Living expenses are increased by five percent and compared to the household-size specific actual medium. The affordable penalty or contribution is then added to the living expenses.

Available cash flow is simply the difference between income and living expenses. Assets are identical across all three columns, and then to determine net worth INDIPAY subtracts the applicant's liabilities, which reflect the affordable penalty or contribution. Debt payments are increased by the annualized affordable penalty, and then divided by the applicant's income.

⁵ The 36-percent default value for the maximum debt payments as a percent of income is based upon the criteria that commercial lenders commonly employ.